Capital in the Twenty-First Century

By Thomas Piketty
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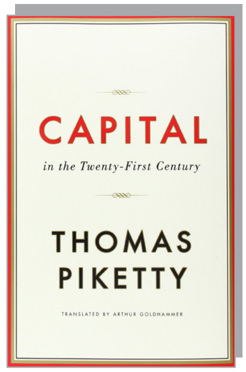


In *Capital in the Twenty-First Century*, Thomas Piketty aims to make the case for both confiscatory taxes on high labour incomes and a tax on the value of capital. He says not only are such taxes morally fair but also necessary to avoid the natural tendency of capitalism to concentrate wealth in fewer and fewer hands. Although the data set he pulls together is impressive, I am less impressed by the explanations given—and resulting policy conclusions.

Piketty flips on its head the common logic of capital deepening—arguing that a society with a growing reliance on capital will experience an increasing concentration of wealth. With population growth rates slowing while average rates of return on investment, and savings rates, remain elevated, capital deepening is likely to occur over the next 100 years. This larger stock of capital will allow a small part of the population to live off rent from inherited income, while the rest of us toil to earn money through work. Furthermore, capital deepening will push up the share of total income that accrues to capital owners.

Piketty views this as a natural consequence of capitalism and current government policy. He views current tax rates as virtually proportional, and believes that the strength of a highly progressive tax system is its ability to prevent *excess* concentration of wealth.

Furthermore, he believes that the negative effects of both confiscatory taxes on income and taxes on capital are overblown. He specifically says: 'The effect of the tax on capital income is not to reduce the total accumulation of wealth but to modify the structure of the wealth distribution over the long run.'

Given these assumptions, he sees a confiscatory tax on high incomes combined with a progressive tax on the value of the capital as the only way to prevent the natural tendency of capitalism to head towards excessive inequality. Furthermore, it is only by preventing excessive inequality that we can protect democracy and the positive elements of free and fair capital trade from being undermined by totalitarianism.

Does Piketty's argument stack up?

At face value, Piketty is raising an important point. Capital deepening, and policies that favour income types, has distributional consequences as well as an impact on total or average GDP. Just like the case of globalisation, this implies a democratic society may need to consider and compensate losers for economic growth to be, what economists call, a Potential Pareto Improvement.

Furthermore, the comparison between Piketty and Marx (one Piketty makes himself) is largely unwarranted. Piketty's view is there are positive and necessary aspects of capitalism, and that we need to use tax policy to save it from itself—in this way, Piketty's writing bears more similarities to that of John M. Keynes than to Karl Marx.

However, the very description of what will happen over the next 100 years is fraught. The justification for capital taxes and high taxes on labour income is to prevent an *inegalitarian spiral*, which Piketty views as the result of the two fundamental laws of capitalism:

1. capital income's share of total income (μ) equals the average rate of return on capital (r) times the capital-to-output ratio (ß)
2. the capital-to-output ratio (ß) equals the net savings rate (s) divided by the rate of growth (g).

These are both true. But it does not necessarily follow that a fall in the growth rate of the economy will lead to a higher capital-to-output ratio—as savings rates are likely to decline. Furthermore, if the capital-to-output ratio does rise, it does not follow that capital income's share must climb—as the average rate of return on capital would decline.

Piketty specifically assumes both these things. In his view, the savings rate will not change in a low growth environment, and the average rate of return will not adjust sufficiently to the higher level of capital (namely, the elasticity of substitution between labour and capital is greater than one).

His basis for assuming that these trends will occur is the excellent data set he has pulled together on wealth and income for a number of countries, especially for France. These assumptions allow him to explain what has occurred over recent centuries, and as a result, he believes they are appropriate—and that they drive a natural tendency in the capitalist system.

However, they are far from the only explanations for the data set he has put forward. Other explanations that fit the given facts are: changes in risk premiums (say, due to changes in the way government treats property rights); changes in the type of technological changes experienced; a systematic (time varying) bias in income measurement; or changes in the demographic profile of the population.

Each of these explanations suggests a very different set of outcomes for the next 100 years, does not rely on the same strong assumptions about the relationship between labour and capital, and offers a different set of policy prescriptions.

But if we accept those assumptions, should we use higher taxes?

Even if we were to accept Piketty's description as true, the arguments for both confiscatory labour income taxes for high incomes, and for a progressive tax on the value of capital, do not follow.

As noted earlier, to justify the tax, Piketty presumes that a lower rate of return on capital, due to a tax on capital, will not lower the size/quantity of the capital stock. Essentially, he views capital accumulation as a process that just takes place, one that bears little relation to the price incentives faced by people within the economy.

As a result of this assumption, his tax on capital does not lower output; it just redistributes within the economy.

This assumption is staggering in its boldness. Capital accumulation is said to be a *macrosocial*, something that we leave outside of our description of the economy as it just happens.

If we were to take a more realistic view that capital accumulation would be hit by a tax on capital, then we know his policy suggestions have a cost—they lead to lower output and a decline in real wages (which are positively related to the amount of capital per worker).

In this case we have a trade-off. Piketty may believe there are real socio-political costs to an increasingly large capital stock, and that a progressive capital tax can help solve this. But if we are then to introduce this tax, we need to recognise that there is the related cost of lower capital and real wages.

While his argument for a progressive capital tax is only partial, the argument for a confiscatory income tax is barely made—and is almost just assumed to be true by default.

To use his own terminology about other economists, his views on income tax appear to be 'suffering from a certain naivety' about the way incomes are paid and remuneration is worked out. In this instance, he states that the high wages paid to *supermanagers* are determined largely by social norms, and are the result of changes in societies' view on what is fair. In that context, the cuts to marginal tax rates during the 1980s are said to have caused the increase in salaries.

Although social norms are always and everywhere fundamentally important, placing tax rates at the centre of this analysis is absurd. The cuts in marginal tax rates and the corresponding tightening up in other tax rules (fringe benefit taxes, tax reporting, accounting conventions) led to a sizable change in the way top employees were remunerated—not just the amount of remuneration. Furthermore, the increasing complexity of large organisations, rise of presumed *superstar* markets for top employees, agency problems within large firms, and the fact that underlying roles have changed so much in the past 30 years have also had an impact on remuneration patterns.

As a result, let's think about Piketty's argument in its full sense. If changes in social norms have allowed remuneration of top employees to rise, there must have been a sufficient surplus generated to pay them that. If the government now lifted the marginal tax rate of high incomes to confiscatory levels, we would see income inequality fall and top wages decline. However, given social norms, we would also see a significant increase in other forms of remuneration—and in ways to remunerate these employees that are not subject to tax. In what ways has the fundamental imbalance in terms of the claim on resources changed here? Yes, we will have nice lower income inequality statistics to show off, but any actual change in remuneration would be down to greater deadweight loss from taxation as firms and superstar employees use inefficient ways of avoiding tax.

Piketty's decision to just assume that high marginal tax rates will change social norms is an unsatisfying, unjustified assumption—and it is the basis of his recommendation for confiscatory income taxes for high incomes.

Even accepting that the voluntary agreement between a firm and its manager to pay 'excessive' wages is unjust, Piketty's solution of confiscatory taxes—which is akin to setting a maximum pay rate—simply does not follow. Instead, we need to ask about the institutional design of firms such that shareholders are paying such significant salaries to supermanagers instead of keeping the earnings for themselves, and why this may matter.

Summing up

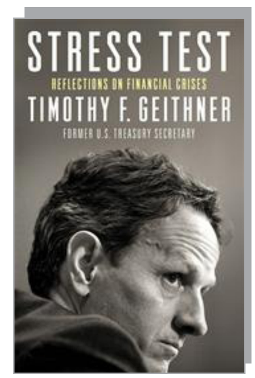
Capital in the Twenty-First Century is an important book. It highlights the impressive data pulled together by Piketty and other authors who followed his lead. Furthermore, it provides a framework to give the data meaning.

However, the policy conclusions of confiscatory tax on high incomes and a progressive tax on capital stand on far shakier ground than Piketty discusses in his book—relying on an empirically false assumption about the elasticity of substitution between labour and capital, strong moral judgments on what is fair, and an obfuscation of some of the real costs associated with his policy prescriptions.

In an ideal world, Piketty's insightful data work will spur economists to understand more about the changing distribution of income and what it means for the welfare of individuals in a society—but not to an acceptance of his hard-to-defend policy prescriptions.

Reviewed by Matt Nolan

Stress Test: Reflections on Financial Crises [Kindle Edition]



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When government financial officers, like Treasury Secretaries and Fed Chairmen, stand at the edge of the cliff of a market panic and stare down into the abyss of potential financial chaos, they always decide upon government intervention. In the first place, nobody wants to go down in the ignominy of being the ones who stood there and did nothing in the face of a financial collapse. Secondly, nobody will or should take the risk of triggering the unnecessary financial and economic destruction of a debt deflation. So they always do and should intervene.

In a panic, the desire for return on capital is replaced by the desire for return of